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CHARTERED FINANCIAL PLANNERS
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EFFECT OF INFLATION

Over time inflation reduces the value of money and what it purchases. This is demonstrated by the following table which shows the effect of inflation on a notional investment of £1,000.

Inflation Rate (% pa)	Real Value 5 years £	Real Value 10 years £	Real Value 15 years £	Real Value 20 years £	Real Value 25 years £
2	905	820	743	673	609
3	862	744	642	554	478
4	822	676	555	456	375
5	783	614	481	377	295
6	747	558	417	312	233
7	713	508	362	258	184
8	680	463	315	215	146
9	650	422	275	178	116
10	621	386	239	148	92

The UK's Consumer Price Index rose to 4% in January, up from 3.7% in December and as such is now double the Government target. At the same time the older inflation measure, Retail Price Index RPI, rose to 5.1%. This has necessitated Mervyn King, the Governor of the Bank of England, writing on behalf of the Monetary Policy Committee to explain why CPI has risen. The Governor and members of the MPC have come under increasing pressure to raise interest rates. Even if central banks refuse to raise base rates, borrowing costs in the market go up anyway whilst higher inflation coupled with a fall in currency make it in even tougher for the UK to sell unindexed, Sterling-denominated debt instruments which is precisely what the majority of the Gilts that are offered for sale by the Government happen to be.

According to the Office for National Statistics the factors that impacted on inflation in January include the increase in the standard rate of VAT to 20% and the continued increase in the price of crude oil. The increase in VAT impacted across the board raising the price of fuels and lubricants, dining out, furniture and furnishings and also the purchase of vehicles. Other factors include big increases in the price of gas, electricity and food and these increases will continue to impact on CPI which may rise as high as 5%. However by the second half of 2011 the lingering effects of Sterling's fall should be receding and assuming there are no more sharp increases in Oil and Commodity prices and the coming budget does not further increase indirect taxes, then we expect inflation should start to fall and next January when this year's VAT rise drops out, it could fall back by about 1% and could continue to fall during the first half of 2012 even as low as the Government target, 2%.

Whilst in theory, cash on deposit appears to be a low risk investment, in reality there is a material risk of the value falling in real terms. This is because whilst interest rates may be about to increase the rate of return from cash on deposit is likely to remain lower than the rate of inflation at least for the next twelve months.

An investor can seek to protect against inflation by investing in the following asset classes:-

- Quoted Shares – ideally non-cyclical companies such as the utilities who are not over borrowed and are able to maintain a dividend.
- Well let Commercial Property either directly or through a Collective Fund such as an authorised unit or investment trust.
- Index Linked National Savings Certificates.
- Index Linked Government Gilts.
- Investment Grade Corporate Bonds.

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